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SUBJECT: CONGRESS APPROVES 2010 SPENDING LEGISLATION

¶1. (SBU) Summary. On November 17, the Mexican Congress approved the 2010 budget, voting 437-25 to pass the spending bill, which includes MX$3.18 trillion (US$244 billion) in outlays. The budget for 2010 implies a deficit of 0.75% of GDP excluding debt from state oil monopoly Pemex, but with Pemex debt rises to 2.75% of GDP -- the largest deficit since 1989. The spending bill moves MX$96.6 billion of spending to infrastructure, social programs, health, education, and agriculture. Over MX$90 billion of this will be taken from operational spending cuts. In addition, the average price forecast for the Mexican basket of crude oil was increased to US$59.0 per barrel from US$53.9 dollars per barrel in President Felipe Calderon's original legislation. The revenue side of the budget passed earlier this month, with legislators watering down tax increases, particularly a proposed additional 2% value-added tax (VAT) on all goods and services. Instead, the general VAT rate, which excludes foodstuffs, health, and education services, was increased from 15% to 16% (from 10% to 11% at the border). The approved tax measures will give the GOM additional resources equivalent to 1.1% of GDP. The approved spending law was 0.5% lower than the approved 2009 budget, with more resources going to social development and infrastructure, but slightly fewer resources to fund non-drug war-related security. Funding for order, security, and justice will increase. While relatively prompt approval of the budget is a success for the GOM, changes to the original proposals highlight the strength of the main opposition PRI in Congress. The lack of structural reforms and insufficient tax increases resulted in a sovereign debt downgrade from Fitch. End Summary.

Expenditures Budget for 2010

¶2. (U) Public expenditures approved by the Congress total MX$3.18 trillion (US$244 billion), which is 0.5% lower in real terms than that approved by the Congress in 2009, but MX$4 billion (US$305 million) higher to the initial proposal. Programmable expenditures allocated to social development, transport and communications and sustainable development increased in real terms by 4.9%, 3.7% and 14.9% respectively, to expenditures approved in ¶2009. The Finance Secretariat affirmed that the 2010 budget will help promote growth as it will ensure macroeconomic stability; inject additional resources obtained from new tax measures into the economy to

stimulate domestic demand (Note: Additional resources were used to service debt in the past. End Note), ensure security funding to fight against organized crime, and promote social development and infrastructure investment.

Impact on Growth, Employment, Inflation and Transparency
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¶3. (SBU) The GOM asserts that with the budget approved for infrastructure, more jobs will be created next year. Responding to criticism about the lack of transparency in public spending and the growth in current expenditures during the past years, lawmakers approved provisions to force the GOM to submit a program to reduce public spending due on March 15th, 2010. States will also be required to adopt performance-based budgeting and submit quarterly reports on the evolution of expenditures. Embassy contact and respected economist Rogelio Ramirez de la O wrote in his opinion column that he doubts the economic package will promote growth as the new taxes will have a negative impact on aggregate consumption, particularly with the current high unemployment rate. Echoing Ramirez de la O's concerns, former deputy governor of the central bank Everardo Elizondo publicly stated that the increase in taxes could affect businesses' cash flow and the expected increase in inflation could complicate monetary policy decisions for next year.

¶4. (SBU) With regard to inflation, the tax increases will have a one-time impact in 1Q10; as a result U/S Alejandro Werner revealed that the Finance Secretariat

may wait to begin increasing energy prices until 2Q10. Most analysts do not expect Banxico to begin hiking until 2Q10, although Banamex speculated that it may implement a preventive 25 bps hike in January to anchor expectations. A survey conducted by Banamex revealed that inflationary expectations for 2010 grew to 4.81% from the previous 4.54% as a result of the tax increases.

Security, Social Development and Infrastructure Budget
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¶5. (SBU) The overall budget of the four GOM security agencies - the Attorney General's Office, the Army, the Navy and the Secretariat of Public Security - was cut by 1.8% from 2009. Total budget for those agencies will be MX$103.8 billion (US$8 billion). However, President Calderon kept his vow of protecting security funds aimed at combating drug cartels. The security budget - commonly known as "order, security and justice", which includes funds for the National Security System, Plataforma Mexico, prisons, the fight against organized crime, etc. - proposed by Calderon amounts to MX$94 billion (US$7.2 billion), 4.9% more than what the Congress approved in 2009. An advisor from the budget committee of the lower house told Econ FSN that although lawmakers have not yet officially issued the total security figures, the amount approved by the lower house will be quite similar to Calderon's proposal, since security remains a priority for all political parties. (Note: The official 2010 Spending Legislation must be published in the Official Gazette by December 15 and will include the total security figures. End Note)

¶6. (SBU) Expenditures for the Social Development and the Communications and Transportation Secretariat grew 12.7% and 5.9%, respectively. According to Jaime Hernandez, Director General of Budgetary Policy of the Finance Secretariat, expenditures in social and economic development represent 60% and 35% respectively, of total public spending. Public investment in infrastructure will be 3.6% larger in real terms with respect to 2009. Investment for Pemex for energy projects will grow 10.5%

in real terms. Private investment triggered by public spending will grow 0.7% from the previous year. Total investment in infrastructure will represent 4.9% of the GDP. Expenditures for social programs, such as Oportunidades and the Popular Health Insurance, grew by 12%, which will help provide support to a combined 16.4 million families in 2010. The approved budget for Oportunidades was MX$64.4 million (US$5 million).

PRI and state governors led the budget negotiations
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¶7. (SBU) The lower house approved the budget under the overwhelming influence of the PRI majority and PRI state governors. Lawmakers prioritized spending and the political needs of state governors, especially those holding elections in 2010 as well as Enrique Pena Nieto, the governor of the State of Mexico, who appears to be atop the list of potential candidates in the runup to the 2012 presidential election. Lawmakers reshuffled MX$96.6 billion of spending, about 3% of the total projected spending to infrastructure, health, education and agriculture programs in the states. Federalized expenditures or resources (participaciones and aportaciones) going to the states will be MX$6.3 billion (US$480 million) higher than the Executive's proposal, but 0.4% lower than what was approved last year. Lawmakers also raised other resources transferred to the states known as Budget Line 23 for public investment and infrastructure programs in states and municipalities by 46.5% from what the Executive had initially proposed. These additional resources were obtained by cutting current expenditures and administrative costs in most of the Secretariats, including the Office of the President. Congress did not approve the elimination of three ministries - Tourism, Agrarian Reform and Public Administration - as proposed by President Calderon, but this represents less than 10% of the expected new tax collection.

Fitch takes the first step in downgrading Mexico
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¶8. (U) As expected, on November 23rd Fitch downgraded Mexico's sovereign debt one notch to BBB from BBB+ with a stable outlook. For Fitch the tax measures were a step in the right direction, but insufficient to reduce the high reliance on oil revenues, which still accounts for over 30% of total revenues. The rating company is also concerned about the GOM debt's reaching 37% of GDP in 2009, which is above peer median. (Note: U/S Werner said that total debt would rise to 38% of GDP in 2010 to begin falling by 2011. End Note) Falling oil production has accentuated the weakness in public finances, leaving Mexico with limited fiscal manipulation in the face of future oil income shocks. Fitch also noted that chances for approval of a more comprehensive tax reform were not bright as the opposition controls the lower house and political dynamics will be heavily influenced by the 2012 presidential elections. Fitch also adjusted the ratings in local and foreign currency for development and commercial banks: Nafin, Banobras, Bancomext and HSBC. It is unlikely that Moody's will downgrade Mexico in the medium term as its Mexico City branch director Alberto Jones recently stated the likelihood for Mexico to be downgraded is very low. It is still uncertain whether S&P will follow Fitch. S&P gave Mexico a negative outlook early in the global recession (March 2009). Now that Mexico is on the recovery path, there is more justification for S&P to avoid a downgrading. S&P could also take into consideration President Calderon's considerable effort in securing an unpopular reform in the middle of a recession and with a Congress controlled by the opposition.

Implications of a downgrade

¶9. (SBU) A downgrade will likely cause the peso to depreciate temporarily and increase GOM borrowing costs. For JP Morgan analysts markets had already "priced-in" a downgrade from Fitch. On November 23, right after Fitch's pronouncement, the IPC - the Mexican Stock Exchange's main index - rose 1.50% and the peso appreciated 0.05% to 13.10 pesos to the dollar. However, JP Morgan notes that markets have not priced-in a downgrade from the other two rating companies. A downgrade could have important implications for major Mexican corporations. The lower rating will make it more costly for Mexico to borrow abroad, and sovereign debt downgrades generally hurt companies based in emerging markets by increasing their cost of capital. Investors tend to demand higher yields from emerging market companies when their home government's ratings are cut, which increases borrowing costs. Sometimes emerging market companies can be better rated than their own governments, although this is generally limited to those that have exceptionally strong balance sheets or extensive operations outside the country where they are based. The week of November 16, after meeting with rating companies Finance Secretary Carstens said that a downgrade would not be good, but would not be disastrous. He later acknowledged that the country's opportunities to get financing from abroad would be narrowed. Several experts have noted that Mexico will still be two notches above investment grade, although closer to Brazil.

GOM Announces New Infrastructure Projects

¶10. (U) On November 19, the GOM held a joint conference in New York City with the Mexican-American Chamber of Commerce to present new infrastructure projects. The GOM announced that there will be 480 infrastructure projects in toll roads, ports, water treatment plants, etc. which will require public-private investment. Mexico's Infrastructure and Public Services Development Bank (Banobras) expects to spend about MX$45 billion (US$3.5 billion) in 2010. The GOM had hoped that this event and the 2010 budget could shield Mexico from a downgrade since it would show that the GOM was doing something to

stimulate domestic demand, economic activity, and job creation.

¶11. (SBU) Comment. The main signal to financial markets was that even in times of economic hardship, a fragmented Congress is unwilling to rein in spending, and Calderon's cabinet was unable to achieve a more comprehensive tax reform to reduce long-term oil dependence. The GOM was unable to mount a political counteroffensive when the PRI shot down the central plank of its revenue proposals, a general 2% VAT rate. There was broad disappointment with the outcome and the intense politicization of the whole budget process. While some applauded the fact that the new taxes will be recycled into the economy, others lamented that the reform did not eliminate tax loopholes or increase efficiency of public spending. The general view going forward is that Mexico will not collapse, nor will it achieve its growth potential, and it will continue to take short-term measures to salvage the next year rather than making medium- or even long-term reforms. Mexico has been deemed as "the champion of muddling through," and unless the GOM is willing to undertake structural reforms in the energy, telecommunications, financial sectors as well as sound improvement in competition and tax collection, Mexico will continue to lose its appeal compared to other emerging economies such as Brazil. End comment.